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IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-819

EUGENE W. LANDY, *et al.*,

Petitioners,

vs.

FEDERAL DEPOSIT INSURANCE CORPORATION, Receiver for the Eatontown National Bank, *et al.*,

Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Third Circuit

BRIEF FOR CERTAIN RESPONDENTS IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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BRIEF FOR CERTAIN RESPONDENTS IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

Respondents file the within brief in opposition to the Petition for a Writ of Certiorari to be issued to review the judgment of the Court of Appeals for the Third Circuit entered in this action on July 30, 1973, rehearing denied August 24, 1973.

Opinions Below

In addition to the opinions set forth in the Appendix to Petition filed herein, these respondents draw this Court's attention to the second unreported opinion of the District Court for the District of New Jersey in this matter, *Landy, et al.* v. *Federal Deposit Insurance Corp., et al.*, Civil Action No. 1561-70 (D. N. J. Dec. 9, 1971) annexed hereto at P-App. 1a-7a.[1] This opinion is the basis for the District Court's final judgment dated January 12, 1972 (R-App. 8a), and was affirmed by Court of Appeals for the Third Circuit, —— F. 2d —— (1973), P-App. 73a-80a; 85a-87a.

Jurisdiction

These Respondents do not question the statement of jurisdiction as set forth in the Petition.

Questions Presented

1. When the undisputed facts adduced on depositions and found on summary judgment not appealed show no reliance by petitioners on financial statements issued by their corporation (a bank), may the petitioners-stockholders of the bank recover from the respondent-stock brokers (member firms) where the bank's president embezzled its funds to invest in the stock market and in concealing the crime caused the bank to issue false financial statements.

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[1] Citations to the Respondent's Appendix hereinafter will appear "R-App. ——." References to the Petitioner's Appendix will appear "P-App. ——."

2. Should this Court overturn the well-settled "purchaser-seller" requirement of *Birnbaum* v. *Newport Steel Corp.*, 193 F. 2d 461 (2nd Cir. 1952) *cert. denied* 343 U. S. 956 (1952) in a case involving "transactions which constitute no more than internal corporate mismanagement" and as such are not remediable as a violation of Section 10(b) of The Securities Exchange Act of 1934 (15 U.S.C. §78j(b)). *Supt. of Insurance* v. *Bankers Life & Cas. Co.*, 404 U. S. 6, 12 (1971).

3. Are not the decisions of the District Court and the Court of Appeals on the disqualification of the petitioners to maintain their claims under Rule 10b-5 consistent with this Court's decisions on "standing" in *Flast* v. *Cohen*, 392 U. S. 83, 99-100 (1968) and *Barlow* v. *Collins*, 397 U. S. 159, 171 (1970) (Separate Opinion, Justice Brennan) and the basic premise that to maintain this action, petitioners must be members of the class for whose benefit Rule 10b-5, 17 C.F.R. §240.10b-5, was adopted. *Kardon* v. *National Gypsum Co.*, 69 F. Supp. 512, 513-514 (E. D. Pa. 1946); Restatement (Second) of Torts, Sec. 286 (1965).

Statute and Regulation Involved

These respondents do not question petitioners' designation of the statute and regulation involved.

Counter-Statement of Facts

Petitioners are Gloria Landy, her uncle, Harry Gross, and a corporation he controlled. Until it was declared insolvent and closed on August 8, 1970, Mrs. Landy's husband, Eugene W. Landy ("Landy") was a Director and Vice President of Eatontown National Bank ("Eaton-

town") as well as its Trust Officer and General Counsel. At various times prior to August 8, 1970, petitioners, acting largely on Landy's recommendations, had purchased Eatontown stock.

Until August 8, 1970, Eatontown's President, Douglas J. Schotte ("Schotte") had used bank funds to speculate in the securities market. In slightly more than three and one-half years, he bought or sold more than $200 million of securities in Eatontown's name through accounts with a number of New York Stock Exchange member firms, including respondents herein.* When Schotte had to pay for the securities, he issued Eatontown cashier's checks.

In other actions, Landy and other Eatontown Directors are now being sued for their failure to properly supervise the affairs of the bank. Nevertheless, in the face of his own substantial responsibility for the losses suffered by Eatontown and its stockholders, Landy instituted suit in the U. S. District Court for the District of New Jersey against the Federal Deposit Insurance Corporation ("FDIC"), as Eatontown's receiver; Edward R. Burt & Co. ("Burt"), Eatontown's accountants; the respondent-member firms, and others.

Among other things, the Complaint contains claims against the member firms asserted by Landy and petitioners (who are also named as plaintiffs) on their own behalf and as purported representatives of all those who purchased Eatontown stock between January 1, 1967, and April 8, 1970. Recovery is sought for the loss in

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* The respondents include member firms who did not implement transactions at the instance of Eatontown. Such member firms served as "clearing brokers" for certain other member firms through which Eatontown executed orders for securities. For purposes of this brief, no distinction will be made among the respondent-member firms.

value of Eatontown stock suffered by plaintiffs and the other Eatontown stockholders when the bank collapsed. Petitioners blame this loss on the fact that they were not informed of Schotte's fraud when they purchased their Eatontown stock. Thus, the keystone of petitioners' case is their allegation that they purchased Eatontown stock "relying on the published financial statements of the Eatontown National Bank" which failed to reveal the fraud. (Complaint, First Count, ¶9, P-App. 93a) In another allegation of the Third Count, paragraph 13, (P-App. 95a) petitioners alleged they "were further defrauded by specific statements made by the above named individual accountant representatives, namely, Burt Cutler, Harvey Katz, Alfred Benjamin, Jr. and Max L. Heine."

In a somewhat redundant allegation (omitted from the petitioners' appendix), paragraph 11 of the same Third Count states:

> "11. The individual defendants, Burt Cutler, Harvey Katz, Alfred Benjamin, Jr. and Max L. Heine, between January 1, 1967 and August 8, 1970, and at various other times, made statements concerning the Eatontown National Bank to the shareholders of the Eatontown National Bank, including statements to Eugene W. Landy. Said statements were false and misleading and omitted material facts since, at no time did they reveal the plan and scheme to defraud as aforesaid."

Petitioners claim that the member firms are answerable for the nondisclosure under Section 10(b) of The Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, because in executing Schotte's trades, the member firms knew or should have known that he was misusing the bank funds and should have communi-

cated this fact directly to Eatontown stockholders. In addition, although it is nowhere specifically alleged in the complaint, petitioners claim, generally, that the member firms "conspired" with Schotte and "aided and abetted" his scheme. We note that petitioners' "Excerpts from from complaint" set forth in their Appendix to the Petition (P-App. 92a), contain no such allegations.

The District Court Decision

The District Court dismissed the claims of the complaint which were asserted against the member firms by petitioners, individually and as purported class representatives. Taking their specific allegations to be true, the District Court held that petitioners had not alleged injury resulting from conduct or omission by the member firms, in connection with the purchase or sale of securities. It pointed out that petitioners were not purchasers or sellers of the $200 million in securities which member firms purchased or sold for Eatontown and that their dealings with the bank were not "sufficiently closely related to the purchase of Eatontown stock to sustain a 10b-5 violation." In the Court's words, petitioners' allegations were "contrived" and an attempt

> "[t]hrough the use of a series of sand bridges . . . to turn the misapplication of bank funds into a securities case by showing that [Eatontown] collapsed as a result of Schotte's thefts and that if the shareholders had been warned in advance they would have sold, not purchased, Eatontown's stock." (P-App. 9a)

Although the District Court was able to dismiss the complaint against the member firms, by assuming the truth of the allegations of the complaint, the motions of the member firms also presented to the Court certain

factual material developed in depositions of petitioners. These depositions clearly established beyond dispute that, in purchasing their Eatontown stock, none of the petitioners relied on the "false and misleading statements and reports regarding the financial condition of Eatontown."

The District Court found, as a matter of fact, such absence of reliance in dismissing the claims petitioners asserted against Burt as purported class representatives (R-App. 4a). The petitioners are bound by these findings of fact since the Third Circuit (P-App. 73a-80a) expressly affirmed the District Court's judgment on this matter (R-App. 8a).

Petitioners have expressly stated they "do not seek certiorari insofar as the Court below affirmed . . . the grant of summary judgment in favor of defendant Edward R. Burt & Co." (Petition, page 11). However, the undenied facts of no reliance on misleading financial statements is inextricably tied to this summary judgment against petitioners. It is a factual finding now final since no timely review has been sought. Further, the undisputed facts are set forth in the trial court's opinion (R-App. 4a).

If petitioners' complaint against the member firms had not been dismissed for failure to state causes of action under Rule 10b-5, it would have been dismissed because of petitioners' own testimony of their nonreliance. The District Court, referring to the depositions of all plaintiffs, treated the claim of fraud referred to in the Third Count, paragraphs 11 above and 13, (P-App. 95a) in the following manner:

> "In addition to non-disclosure plaintiffs argue that there were affirmative misrepresentations by

> some of the brokers. However, during depositions, only plaintiff Landy could expand on these allegations and his answers established only that the named brokers never volunteered to him that they were doing business with the bank. He in turn never asked if they were, and neither side made any representations concerning the general nature of these activities.[18] I do not find these conversations to be affirmative misrepresentations. Landy's case on disclosure must be examined on the theory of some duty to disclose, and upon examination I conclude that no such duty was established. . . ."

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[18] See Transcript of deposition of Henry Gross, Gloria Landy and Eugene Landy (Mar. 15, 1971), pp. 114 et seq." (P-App. 12a).

The Third Circuit in its opinion made reference to the very same allegations as to alleged specific false and misleading statements made by the individual registered representatives-defendants employed by some of the respondents herein. It concluded that summary judgment issued by the District Court was proper, noting that "there is no indication on appeal that plaintiffs desired to or could produce additional relevant evidence." (P-App. 60a-61a)

The District Court dismissed petitioners' aiding and abetting conspiracy arguments, holding that "the facts alleged in the present case simply cannot support such a theory." As the District Court explained:

> ". . . The fraud in which the brokers are alleged to have aided or conspired with Schotte was the fraud concerning the $200,000,000 in security transfers not the fraud against the shareholders. The allegation of a second fraud is a mere conclusory allegation not supported by the fact set forth in the com-

plaint. The brokers were not involved in any transaction with regard to Eatontown shares, they did not make any representations concerning same, no reliance upon any broker activity is alleged, no duty of disclosure was breached, and finally, there was no allegation that the brokers knew or took part in the preparation or dissemination of any false financial statements which Douglas Schotte is alleged to have engineered." (P-App. 13a)

Affirmance by the Third Circuit

The Court of Appeals for the Third Circuit affirmed the District Court's dismissal of petitioners' individual and purported class claims against the member firms. Like the District Court, the Court of Appeals found that the relationship between the member firms selling and buying securities for Schotte and plaintiffs' purchase of Eatontown stock, was "remote and no stretch of the imagination suggests that plaintiffs relied upon these acts in their purchase of ENB shares." (P-App. 62a) Likewise, it rejected the conspiracy and aiding and abetting arguments, specifically holding that "(1) liability [on the part of the member firms] for aiding and abetting Schotte in his misstatements was not alleged in the complaint." (P-App. 64a-65a). In addition, it determined there were no facts supporting these claims.

Reasons for Denying the Writ

Petitioners urge this Court to issue a Writ of Certiorari to review the Third Circuit's affirmance of the dismissal of petitioners' individual and purported class claims against the member firms. Summarizing the allegations of the complaint, the petition states:

> "The complaint alleges that the secret trading through the respondent brokers constituted a single, unified plan, scheme and device to defraud Eatontown, purchasers of Eatontown's common stock and all of Eatontown's shareholders in violation of Section 10(b) of the Exchange Act Rule 10b-5 thereunder (App. 93a-94a). The complaint further alleges that as part of this unified fraudulent conspiracy Schotte made statements to the named petitioners and sent reports and other communications to all the shareholders of Eatontown which were false and misleading in that they failed to disclose the liabilities of Eatontown arising from the fraudulent conspiracy (App. 93a). Petitioners and the other members of the class represented by them purchased Eatontown common stock in reliance on such false and misleading statements, reports and other communications (App. 93a)." (Petition, pages 7-8)

Stripped of its generalities and carefully worded half-statements, the only reasons advanced by the Petition for granting the requested Writ are:

a. The claim that the decision of the Third Circuit is in conflict with the decision of this Court in *Superintendent of Insurance* v. *Bankers Life & Cas. Co.*, 404 U.S. 6 (1971) and the decision of the Court of Appeals for the First Circuit in *Ferguson* v. *Omnimedia Inc.*, 469 F.2d 194 (1972).

b. An invitation for this Court to take the drastic step of overruling the long accepted "purchaser-seller" requirement of *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d. Cir.), *cert. denied* 343 U.S. 956 (1952), which would give every stockholder a 10b-5 cause of action to recover for the loss of value in his stock whenever his corporation had been injured by self-dealing, embezzlement or other

"garden variety types of fraud" committed by management.

c. A plea that this Court should reinstate an otherwise fatally defective complaint on the basis of a claim of conspiracy and aiding and abetting which is not alleged in the complaint or supported by any specific factual allegations.

d. A suggestion of a nonexistent conflict between the decisions of this Court with respect to the question of standing, and the decision of the Third Circuit which did not truly involve the question of standing but rather the question of whether or not a cause of action was stated under Rule 10b-5, i.e., whether the petitioners had a legally protected interest which the respondents' actions invaded. *Flast* v. *Cohen*, 292 U.S. 83, 99 (1968); *Barlow* v. *Collins*, 397 U.S. 159, 171 (1970) (Separate Opinion, Justice Brennan).

ARGUMENT

I.

The District Court's final decision that petitioners, in purchasing their Eatontown stock, did not rely on alleged misstatements of financial condition is sufficient basis for affirming dismissal of their complaint and, consequently, the questions of law petitioners ask this Court to review are not raised by the decision of the Third Circuit.

As characterized by their own Petition, page 15, a crucial element of petitioners case is their alleged reliance on the financial statements in purchasing Eatontown stock. Absent such reliance, their individual claims fail and their status as purported class representatives

is destroyed, regardless of the resolution of the legal issues petitioners seek to have reviewed by this Court. *List* v. *Fashion Park, Inc.*, 340 F2d 457, 462 (2nd Cir., 1965), *cert. denied*, 382 U.S. 811 (1965). We find no case supporting any obligation to disclose, and without this the requisite element of causation is missing. *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 154 (1972). We disagree with the Petition at page 15, and cannot find any reference in the Third Circuit opinion that the "respondent brokers knew or should have known that such false financials were being issued for that purpose. (App. 29a, 66a)"

In any event, the record on this petition is such that there is a final determination against petitioners' reliance on false financial statements. No evidence was available to petitioners at any stage of the litigation to negate this factual determination, and the Third Circuit made specific mention of this fact in its opinion (See complete factual presentation on this issue, *supra* pages 6-8.).

As petitioners lack of reliance is a sufficient basis for sustaining dismissal of their individual and purported class claims against the member firms, the requested review of the decision of the Third Circuit does not require resolution of the various legal questions which petitioners urge this Court to consider. That being so, this Court should not grant the requested Writ of Certiorari.

II.

None of petitioners' reasons for granting the requested writ satisfy any of the criteria relied on by this Court in granting Writs of Certiorari, as stated in Rule 19.

A. Because it is in harmony with this Court's decision in *Superintendent of Insurance* v. *Bankers Life and Cas. Co.*, 404 U.S. 6, (1971), the decision of the Third Circuit does not involve an important unsettled question of federal law.

In sustaining dismissal of petitioners' individual and class claims against the member firms, the Third Circuit merely held that whatever loss was sustained did not result, in the normal course, from the alleged fraud of the member firms "in connection with the purchase" of Eatontown stock by Petitioners and those they purported to represent (P-App. 52a). As pointed out by the opinions below, petitioners were not purchasers of the $200 million of securities the member firms bought and sold for Eatontown and their conduct was so removed from petitioners' purchase of Eatontown stock that petitioners were not within the "class of protected persons" envisioned by Section 10(b) or Rule 10b-5 (P-App. 55a-56a).

Petitioners' claims here are contrived. In order to create a claim they attempt to become parties to the securities transactions between Eatontown and these respondents-member firms which they contend were fraudulent as to Eatontown. The fact is that Eatontown shareholders were not parties to or in any way involved in the fraud allegedly practiced upon Eatontown by the member firms. The damage which petitioners allege is damage to the corporation, not to the shareholders as purchasers or sellers of securities. The claim asserted here is derivative, not personal. The loss, if any, which petitioners

here complain of arises from the fact of their ownership of Eatontown securities and the diminution in value those shares may suffer if the corporation is not made whole for its losses, not from any fraud practiced upon them by the respondents in connection with their purchases of Eatontown securities.

Petitioners argue that this Court's decision in *Superintendent of Insurance* v. *Bankers Life and Casualty Company*, 404 U.S. 6 (1971), would grant them the right to sue in their own behalf for damages since they allege they purchased Eatontown securities and there was fraud allegedly used in connection with the transactions between the member firms and Eatontown. Thus, petitioners must necessarily erroneously conclude that since Eatontown may allege a Section 10(b) claim in connection with Eatontown's transactions with the member firms, and the petitioners purchased Eatontown's securities, they therefore have a direct claim under Section 10(b) against the member firms.

Such a strained conclusion can only be based upon an erroneous assumption that under the holding and rationale of *Superintendent of Insurance*, petitioners need no longer be purchasers or sellers in connection with the fraudulent transaction alleged. *Superintendent of Insurance* did not reach that conclusion.

This Court, instead of "eschewing" the *Birnbaum* doctrine in *Superintendent of Insurance* as the petitioners state, clearly was relying upon it, *sub silentio*. One must analyze the facts to understand the result. The plaintiff's predecessor, Manhattan Casualty Co., had sold Treasury Bonds. The fraudulent scheme was to use the proceeds of the sale of Treasury Bonds to gain control over Manhattan Casualty Co. by purchasing from Bankers Life its Manhattan shares. Manhattan's Board of

Directors was allegedly deceived into authorizing the sale by the misrepresentation that the proceeds of the sale would be used to purchase a certificate of deposit of equal value. Plaintiff sued for damages. Thus, there was "an act or practice" (the deception on Manhattan's Board) which operated as a fraud or deceit on Manhattan in connection with its sale of the Treasury Bonds.

The Court's opinion starts by defining the issue presented under Section 10(b):

> "Manhattan Casualty Co., now represented by petitioner, New York's Superintendent of Insurance, was, it is alleged, defrauded in the sale of certain securities in violation of . . . §10(b) of the Securities Exchange Act of 1934 . . ." (404 U.S. at p. 7)

Justice Douglas was precise in limiting the Court's holding to the sale of the Treasury Bonds while carefully indicating that §10(b) was not directed to regulation of "internal corporate mismanagement":

> "We agree that Congress by §10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement." (404 U.S. at p. 12)
>
> • • •
>
> "We hold that the alleged fraud is cognizable under §10(b) and Rule 10b-5 in the bond sale . . ." (Footnote 10, 404 U.S. at p. 13)

Moreover, Justice Douglas specifically reaffirmed that the fraud must be "in connection with the purchase or sale":

> "Since there was a 'sale' of a security and since fraud was used 'in connection with' it, there is redress under §10(b) . . ." (404 U.S. at p. 12)

This Court's *Superintendent of Insurance* decision is not revolutionary. It does not destroy the *Birnbaum* rule in damage actions. It merely reaffirms that where there has been purchase or sale of a security and there has been fraud in connection with that purchase or sale (the sale of the Treasury Bonds), a complaint under Section 10(b) is viable, notwithstanding the fact that the transaction did not affect the integrity of the securities markets (the rationale used by the Second Circuit in affirming the District Court's dismissal).

This interpretation of the *Superintendent of Insurance* case is supported by the *Mount Clemens Industries, Inc.* v. *Bell,* 464 F.2d 339 (9th Cir. 1972), and *G.A.F. Corporation* v. *Milstein,* 453 F.2d 709 (2nd Cir. 1971), *cert. denied* 406 U.S. 910 (1971).

The Second Circuit's reversal of its prior affirmance in *Drachman* v. *Harvey,* 453 F.2d 736 (2nd Cir. 1972) did not change the requirement that there be a fraud in connection with the securities transaction. There, plaintiff alleged that the shareholders suffered a loss as a result of a conspiracy which resulted in "an improvident redemption of convertible debentures." The Circuit Court, on rehearing, held that a redemption was a "purchase" and that "a sufficient claim is stated of fraud against the corporation in connection with the redemption of the debentures" (453 F.2d at 737).

The *Drachman* decision (453 F.2d at 738), expressly refused to review and repudiate the *Birnbaum* purchaser-seller rule on the basis of *Superintendent of Insurance.* In view of this treatment, we question the contrary implication gleaned from a reading of *Jannes* v. *Microwave Communications, Inc.,* 461 F.2d 525, 529-530 (footnote 3 and related text) (7th Cir. 1972). We are also not unmindful of the Seventh Circuit's later decision in *Eason* v. *General Motors Acceptance Corporation,* CCH Fed.

Securities L. Reptr. ¶94,344 —— F.2d —— (7th Cir., Dec. 28, 1973) which we treat below.

Thus, in two cases since *Superintendent of Insurance, Drachman* v. *Harvey* and *G.A.F.* v. *Milstein,* the Second Circuit has in one held a §10b action to exist where there was a purchase, and in the other refused to extend §10b to actions where the plaintiff is not a purchaser or seller. See, also *Fershtman* v. *Schectman,* 450 F.2d 1357 (2d Cir. 1971), *cert. denied* 405 U.S. 1066, (1972) (plaintiffs argued in the certiorari petition that the purchaser-seller doctrine should be abolished since the Second Circuit had assumed that they were not "forced sellers").

Instead of being contra to this Court's teaching in *Superintendent of Insurance* as the petitioners here imply, District Judge Whipple did what the Supreme Court subsequently did in *Superintendent of Insurance* by analyzing the complaint to see whether the fraud alleged [the purchase and sale by Eatontown of various securities through the member firms] was related to the purchase or sale by the complaining parties. In *Superintendent of Insurance,* the finding was affirmative. Here, it was negative. The necessary casual connection between the purchases of Eatontown stock by petitioners and the fraud alleged is missing. Judge Whipple's analysis of the "sand bridges" built by the shareholders is correct. (P-App. 9a)

If Schotte, the embezzling Eatontown Bank president, had used the stolen bank funds to bet on the horses or invest in a speculative business venture unrelated to securities, instead of wagering on the stock market, we seriously question whether petitioners could have in good faith framed their complaint as a "garden variety" securities act case. Should they be permitted to turn this "garden variety" fraud-internal corporate mismanage-

ment case into a Rule 10b-5 action by reason of the fortuitous object of Mr. Schotte's crime? To state the question is to suggest the full implication of permitting petitioners to maintain a cause of action for the loss of value of their stock investment. Their petition here should be denied on the basis of *Superintendent of Insurance.*

B. The Third Circuit's decision denying Petitioners' claims because they were not purchasers or sellers is consistent with the "standing" decisions of this Court as embodied in *Flast* v. *Cohen,* 392 U.S. 83 (1968).

The Petition, pages 34 et seq., seeks to overturn the result below because it is posited upon the perhaps unfortunate use of the word "standing" when denying the petitioners the right to maintain their claims herein. But not so. The following illuminating language from the Third Circuit's opinion bears repetition:

> "Rule 10b-5's expanded zone of interests under *Bankers Life* would, nevertheless, not encompass the plaintiffs' interest in this case. They did not engage in any market transactions with the defendants by which they sustained their losses. Were we to extend the provisions of section 10(b) beyond the buyer or seller relationship, we would be *judicially extending the terms of the statute and creating new rights.* The consequences of the view urged by plaintiffs would establish a new and amorphous body of rights and obligations heretofore unrecognized in federal jurisdiction. Buyer or seller status is indispensable in establishing liability for damages under rule 10b-5.
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> • • •
>
> Barring the plaintiffs from maintaining a private right of action is also consistent with the gen-

erally applicable rules of standing. Apart from Article III jurisdictional problems, the standing question involves rules developed by the judiciary in the exercise of self-restraint. *Association of Data Processing Service Organizations, Inc.* v. *Camp,* 397 U.S. 150, 154; *Barrows* v. *Jackson,* 346 U.S. 249, 255 (1953). Normally, standing is accorded only where 'the interest sought to be protected or regulated by the complaint is arguably within the zone of interests to be protected or regulated by the statute or constitutional guarantee in question.' 397 U.S. at 153. *Because these plaintiffs are not within that zone, they have no standing to assert violations of rule 10b-5.*

This conclusion is also consistent with the well established rule that injury flowing directly to the corporation does not create a primary right of action in shareholders. *See United Copper Securities Co.* v. *Amalgamated Copper Co.,* 244 U.S. 261, 263 (1917); *Ash* v. *International Business Machines, Inc.,* 434 F.2d 727, 732 (3d Cir. 1970) [*cert. denied* 401 U.S. 974 (1970)]." (P-App. 56a-57a) [Emphasis added.]

In *Flast* v. *Cohen, supra,* this Court recognized the problem presented by the distinction between the substantive legal right to be litigated, and the proper party to have that substantive right adjudicated as follows:

". . . The fundamental aspect of standing is that it focuses on the party seeking to get his complaint before a federal court and not on the issues he wishes to have adjudicated. The 'gist of the question of standing' is whether the party seeking relief has 'alleged such a personal stake in the outcome of the controversy as to assure that concrete

> adverseness which sharpens the presentation of issues upon which the court so largely depends for illumination of difficult constitutional questions.' *Baker* v. *Carr*, 369 US 186, 204 7 L Ed 2d 663, 82 S Ct 691 (1962). In other words, when standing is placed in issue in a case, the question is whether the person whose standing is challenged is a proper party to request an adjudication of a particular issue and not whether the issue itself is justiciable. . . ." 392 U.S. at 99.

Justice Brennan, in his separate opinion in *Barlow* v. *Collins*, 397 U.S. 159 (1969) makes this distinction clear:

> "'In other words,' we said in Flast, 'when standing is placed in issue in a case, the question is whether the person whose standing is challenged is a proper party to request an adjudication of a particular issue' and not whether the controversy is otherwise justiciable, or whether, on the merits, the plaintiff has a legally protected interest which the defendant's action invaded. . . ." 397 U.S. at 171

The error of petitioners' views, and the perhaps inarticulate use by the myriad of decisions throughout the country which deny non purchasers or sellers the right to maintain Rule 10b-5 actions using the description that those parties lack "standing", is that in reality, no legally protected interest has been invaded by the defendant's action. In other words, in interpreting the judicially created cause of action out of Rule 10b-5, these "purchaser-seller" courts have not reached a "standing" determination, but rather a result that the particular plaintiff failed to state a claim upon which relief can be granted. Cf. *Barlow* v. *Collins*, 397 U.S. at 171, footnote 3.

The resolution of the issue whether in a particular case the purchaser-seller requirement has been met is a matter of substantive law, and the Third Circuit's opinion below recognized this when it said, (as quoted above):

> ". . . Were we to extend the provision of section 10(b) beyond the buyer or seller relationship, we would be judicially extending the terms of the statute and creating new rights. . . ." (P-App. 56a)

In *Eason* v. *General Motors Acceptance Corporation, supra,* the Seventh Circuit discussed this principle in the context of the genesis of Rule 10b-5—Judge Kirkpatrick's opinion in *Kardon* v. *National Gypsum Co.,* 69 F.Supp. 512 (E.D. Pa. 1946). (CCH Sec. L. Reptr. ¶94,344, at pages 95,161-95,162)

Simply stated, the Rule 10b-5 tort remedy contemplated by the Restatement, Torts, Sec. 286, Judge Kirkpatrick (and the Seventh Circuit) is only available to those members of the class for whose benefit Rule 10b-5 was adopted. *Ibid.* We suggest that when approached from this view, no case supports the result that persons other than purchasers or sellers are within the protected class, i.e. no legally protected interest has been invaded. *Mount Clemens Industries, Inc.* v. *Bell, supra,* 464 F.2d at 343-344.

Since the plaintiffs in *Eason* had guaranteed the delivery of notes issued to GMAC as a very important part of the *same transaction* which saw the issuance of 7,000 shares of stock by the guarantors' corporation, there was a direct relationship between the guarantors and the defendant GMAC which in substance could easily have classified them as sellers, although the *Eason* court rejected this view. (Page 95,160) The result in *Eason* is not inconsistent with the requirement that plaintiffs in

any Rule 10b-5 action must demonstrate their membership in the class deserving protection by the statute or regulation, in this case purchasers or sellers, or persons akin thereto as the facts warrant.

C. An interpretation of the Securities Exchange Act of 1934 eliminating the purchaser-seller requirement should be made by Congress.

The purchaser-seller requirement first clearly articulated in *Birnbaum* v. *Newport Steel Corp.*, *supra*, has been the law applied by every Court of Appeals reaching the subject, until *Eason* where the ink is barely dry. *Mount Clemens Industries, Inc.* v. *Bell*, *supra*, 464 F.2d at 342, footnote 5 and related text; *Rekant* v. *Desser*, 425 F.2d 872, 877 (5th Cir. 1970).

This Court in *Blau* v. *Lehman*, 368 U.S. 403, 413 (1962), speaking of another provision of the Exchange Act, observed

> ". . . Congress can and might amend [the act] if the Commission would present to it the policy arguments it has presented to us, but we think that Congress is the proper agency to change an interpretation of the Act unbroken since its passage, if change is to be made."

See *Iroquois Industries, Inc.* v. *Syracuse China Corporation*, 417 F.2d 963, 969 (2nd Cir. 1969), *cert. denied* 399 U.S. 909 (1970); *Mount Clemens Industries, Inc.* v. *Bell*, *supra*, at 343.

To abandon this well established principle would be capitulation to the attempts by the S.E.C. (*Drachman* v. *Harvey*, *supra*, 453 F.2d at 738) and all other unsuccessful plaintiffs who were not purchasers or sellers, to

take "garden variety" types of fraud (*Supt. of Insurance* v. *Bankers Life & Cas. Co., supra,* 404 U.S. at p. 10, footnote 7) and create a new federal remedy. As the Second Circuit said in *Iroquois, supra*:

> "That the conduct averred in any given case may be reprehensible does not mean that a federal remedy must be furnished by judges. The remedy in many cases may be found in the State courts . . ." 417 F.2d at 969.

The result desired by Petitioners herein would result in an abandonment of this Court's rule in *Blau* v. *Lehman,* and for this reason the Third Circuit's result should stand.

D. Petitioners are not within the rule of *Ferguson* v. *Omnimedia, Inc.*, 469 F.2d 194 (1st Cir. 1972) and no conflict is thereby presented.

Ferguson, relied upon by petitioners, (Petition, pages 15 et seq.) holds that where on summary judgment, facts in affidavit form are before the court showing knowledge about any participation in any illegal scheme to defraud the complaining party, a cause of action may be maintained and each "conspirator" held for the acts of "a co-conspirator that actually misled the appellant into buying stock . . . even if she herself did not participate in those acts. (Citation omitted.)" 469 F.2d at 197.

The case at bar does not present facts warranting the application of the *Ferguson* rule, and the decisions below are not inconsistent with it.

No knowledge of Schotte's fraud in the issuance of false financial statements is charged to these respondents, and the undeniable facts are that none participated. To prop-

erly ring in the member firm stockbrokers, respondents herein, some overt act relating to this fraud must be pleaded and proved. Non disclosure, assuming knowledge, is not enough. *See 2 Bromberg*, Securities Law-Fraud-S.E.C. Rule 10b-5, §8.5 (547) (1970).

Before *Ferguson* can be applied petitioners must demonstrate some claim cognizable by our federal courts by the alleged conspirators. In other words, first petitioners must show their right to recover under Rule 10b-5 against one conspirator before they can ask that liability be imposed on (unsuspecting) co-conspirators. We have demonstrated above that summary judgment has been granted against petitioners because they were shown to have purchased their stock independent of any reference to financial statements. This being so, what joint liability can be fashioned against respondents?

The court below did not fail to apply *Ferguson* type logic to this case since no viable claim was made out by petitioners under Rule 10b-5 against any person.

CONCLUSION

For all the reasons expressed above, these respondents urge this Court to deny the Petition for a Writ of Certiorari to Court of Appeals for the Third Circuit and allow its decision to remain standing. This matter is not one factually justifying a departure from the *Birnbaum* purchaser-seller rule, and in any event this Court should decline the invitation to abandon this long standing interpretation of Rule 10b-5 in favor of Congressional action.

January 30, 1974.

Respectfully submitted,

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[APPENDICES FOLLOW]

APPENDIX A

Opinion of the United States District Court for the District of New Jersey

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

CIVIL ACTION No. 1561-70

EUGENE W. LANDY, *et al.*,

Plaintiffs,

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, Receiver of the Eatontown National Bank, *et al.*,

Defendants.

Appearances:

EUGENE W. LANDY, ESQ.
Pro se

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By: DANIEL J. O'HERN, Esq.
Attorneys for plaintiffs, Gloria Landy, Harry Gross and Freehold Glass Co., Inc.

HANNOCH, WEISMAN, STERN & BESSER, Esqs.
By: RONALD M. STURTZ, Esq.
Attorneys for defendant Edward R. Burt and Company

Appendix A

PARSONS, CANZONA, BLAIR & WARREN, Esqs.
By: JOHN WARREN, JR., Esq.
Attorneys for defendant Federal Deposit Insurance Corporation

WHIPPLE, District Judge:

This matter is before the Court on defendant Edward R. Burt and Company's (Burt) motion for summary judgment and to prevent a class action from being maintained by plaintiffs, Eugene W. Landy, Gloria Landy, Harry Gross and Freehold Glass Company, Inc.

Plaintiffs sued other defendants and Burt, an independent certified public accountant, alleging it was retained in 1967 through 1970 to prepare and certify the Eatontown National Bank's (ENB) financial statements. They further alleged that Burt was negligent or grossly negligent in its failure to discover the millions of dollars in liabilities which ENB had incurred. The plaintiffs also contend that financial statements issued by Burt were false and misleading and that plaintiffs relied upon them in purchasing ENB's stock. At oral argument the plaintiff Eugene W. Landy stated that as a director he received special reports from Burt certifying ENB's sound financial position. The last report was received one month before the failure of the bank. In their complaint plaintiffs charge that Burt's conduct constituted both a violation of Rule 10b-5 of Section 10 of the Securities Exchange Act of 1934, 15 U.S.C. § 78j and an act of negligence under the Common Law of the State of New Jersey. Plaintiffs sue on behalf of a class of shareholders who purchased shares between January 1, 1967 and August 8, 1970 in reliance on Burt's financial statements.

Appendix A

In its Opinion and Order of September 9, 1971 this Court refused to dismiss plaintiffs' action against Burt. *Eugene W. Landy, et al.* v. *Federal Deposit Insurance Corporation, et al.*, C 1561-70, D. N. J., September 9, 1971. This Court found that Burt was in a special position as auditor for ENB, and that gross negligence as is alleged in the complaint can or may support a fraud charge when coupled with affirmative representations to the plaintiff. See *Landy*, supra, at 20.

Defendant Burt relies primarily upon *Wessel* v. *Buhler*, 437 F. 2d 279 (9th Cir. 1971) in moving for summary judgment. In that case plaintiffs claimed that accountants' financial statements were in and of themselves misleading for the purchase and sale of securities within the meaning of Rule 10b-5 and that the accountants knew, or should have known, such statements were to be used in preparing prospectuses which in turn related to securities being purchased and sold. No liability under 10b-5 was found by that court since there wasn't evidence that the financial statements were made in connection with purchasing and selling securities. On the contrary, the statements were not publicly disseminated and no investor saw the statements until after the commencement of litigation. *Wessel*, supra, at 282. Moreover, the accountant delivered the financial statements to the Board of Directors for uses unconnected with stock issuance. *Wessel*, supra. That court also held selective use of accountant's figures in a misleading prospectus is not actionable for the following reasons:

(1) No evidence was introduced that the figures were not prepared in accordance with good accounting practice;

(2) There was no evidence to prove the accountant was responsible for the prospectus. *Wessel,* supra, at 283.

It is uncontroverted that plaintiffs, Gloria Landy, Harry Gross and Freehold Glass Company, did not have access to any financial reports prepared by Burt. Plaintiffs assert that an affirmative material misrepresentation was made to ENB by Burt which ENB relied upon in issuing the false and misleading statements "in a manner reasonably calculated to influence the investing public." See *SEC* v. *Texas Gulf Sulphur Co.,* 401 F. 2d 833, 862 (2d Cir. 1968). Plaintiffs claim the report sent by ENB to shareholders constituted an affirmative material misrepresentation and that plaintiffs relied upon the report in purchasing bank stock. See *Ultramares Corp.* v. *Touche,* 255 N. Y. 170, 174 N. E. 441 (1931). The opinion in *Wessel,* supra, raises the question of whether there could have been an affirmative misrepresentation to plaintiffs, Gloria Landy, Harry Gross and Freehold Glass Company. It is the opinion of this Court that there was no misrepresentation by Burt to these plaintiffs. *Fisher* v. *Kletz,* 266 F. Supp. 180 (S. D. N. Y. 1967). Moreover, there is another basis for granting the motion for summary judgment against these three plaintiffs. The uncontroverted proofs before this Court are that plaintiffs, Gloria Landy, Harry Gross and Freehold Glass Company, did not rely upon any written report in their purchase of stock. While these three plaintiffs alleged in their complaint that they releid upon Burt's statements, their depositions prove otherwise. Reliance is a necessary element of either a 10b-5 fraud action or a New Jersey Common Law fraud action. See *Fisher* v. *Kletz,* supra; *Parker Precision Products Co.* v. *Metropolitan Life Ins. Co.,* 407 F. 2d 1070 (3d Cir. 1969).

Appendix A

Mrs. Gloria Landy testified it was in reliance on her personal observations at the bank, her knowledge of friends who had become depositors and her conservations with her husband, Eugene W. Landy, that she purchased the bank stock in question (See Depositions, March 15, 1971, p. 68 and 74). Harry Gross, Mr. Landy's uncle by marriage, acknowledged receiving the bank's annual and semi-annual reports (Depositions, supra, at 16 and 27). However, Mr. Gross could not testify as to any purchase made in reliance upon any report. Mr. Gross also stated that he relied upon Mr. Landy in buying ENB stock (Depositions at 8 and 10). While there is testimony that Mr. Gross relied on the fact that the bank was audited and examined, there is no proof of reliance upon the alleged misleading representations. The plaintiffs, Freehold Glass Company, Inc., is wholly owned by plaintiff, Harry Gross, and his family and is admittedly controlled by Mr. Gross.

These proofs having been submitted in accordance with Rule 56(e) of the Federal Rules of Civil Procedure, and the plaintiff having failed to respond by showing genuine issues of fact for trial, the motion for summary judgment is granted against plaintiffs, Gloria Landy, Harry Gross and Freehold Glass Company, Inc.[1] The summary judg-

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[1] Rule 56(e) Fed. R. Civ. P. provides in relevant part:

> "* * * When a motion for summary judgment is made and supported as provided in this rule, an adverse party may not rest upon the mere allegations or denials of his pleading, but his response by affidavits or as otherwise provided in this rule, must set forth specific facts showing that there is a genuine issue for trial. If he does not so respond, summary judgment, if appropriate, shall be entered against him."

ment motion against plaintiff, Eugene W. Landy, is denied. There is evidence that Mr. Landy was a recipient of Burt's financial reports. Therefore, the questions of gross negligence by Burt and the likelihood of reliance must await a plenary trial.

II

The plaintiff, Eugene W. Landy, cannot maintain this suit as a class action in accordance with Rule 23 of the Fed. R. Civ. P.[2] Mr. Landy's claim is atypical of any class

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[2] Rule 23(a), (b) Fed. R. Civ. P. provides in relevant part:

> "One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.
>
> An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition: * * *
>
> "(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action."

of shareholders since peculiar representations were made to Mr. Landy alone in his capacity as a director and officer of ENB. See *Green* v. *Wolf Corp.*, 406 F. 2d 291, (2d Cir. 1968), cert. denied in *Troster, Singer & Co.* v. *Green,* 395 U. S. 977 (1969). As an insider, Mr. Landy had access to information and had conversations with representatives of Burt, which facts are solely peculiar to his cause of action. Indeed, Mr. Landy will attempt to prove the element of reliance upon facts not common to other members of the class. Thus, the questions of fact common to the class of shareholders are quite dissimilar from those alleged by Mr. Landy.

Accordingly, the class action cannot be maintained and is ordered dismissed. To repeat, summary judgment against plaintiffs, Gloria Landy, Harry Gross and Freehold Glass Company, Inc., is granted. The motion for summary judgment against the plaintiff, Eugene W. Landy, is denied, without costs.

The movant will prepare an appropriate order in conformity with this Opinion.

LAWRENCE A. WHIPPLE
United States District Judge

FILED December 9, 1971

APPENDIX B

Final Judgment Dismissing all Claims of Gloria Landy, Harry Gross and Freehold Glass Co., Inc. and Claims of Eugene W. Landy as Purported Class Representative, Against Edward R. Burt & Company

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

CIVIL ACTION No. 1561-70

EUGENE W. LANDY, *et al.*,

Plaintiffs,

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, Receiver of the Eatontown National Bank, *et al.*,

Defendants.

This matter being opened to the Court by Hannoch, Weisman, Stern & Besser, Esqs. (Ronald M. Sturtz, Esq. appearing), attorneys for defendant, Edward R. Burt & Company, in the presence of Eugene W. Landy, Esq., plaintiff, Pro se; Abramoff, Apy & O'Hern, Esqs. (Daniel J. O'Hern, Esq. appearing), attorneys for plaintiffs, Gloria Landy, Harry Gross and Freehold Glass Co., Inc.; and Parsons, Canzona, Blair & Warren, Esqs. (John Warren, Jr., Esq. appearing), attorney for defendant, Federal Deposit Insurance Corporation; upon defendant Edward R. Burt & Company's motion for summary judgment and to determine that the plaintiffs cannot maintain the within

action as to class representatives, and the Court having considered all of the pleadings, depositions, affidavits, briefs, arguments of counsel, and the records and files in this Court and cause, there being no just reason for delay, and for good cause shown

It is on this 12th day of January, 1972, FINALLY ORDERED AND ADJUDGED:

1. This Court's opinion on defendant Edward R. Burt & Company's motion for summary judgment filed on December 9, 1971, shall constitute its findings of fact and conclusions of law.

2. All claims made by plaintiffs Gloria Landy, Harry Gross and Freehold Glass Co., Inc. against defendant Edward R. Burt & Company, as set forth in Count 34 of the Complaint, be and they are hereby dismissed with prejudice.

3. All claims made by Plaintiff Eugene W. Landy as a purported class representative against defendant Edward R. Burt & Company, as set forth in Count 34 of the Complaint, be and they are hereby dismissed with prejudice.

4. Defendant Edward R. Burt & Company's motion for summary judgment against Eugene W. Landy, individually, on his claims set forth in Count 34 of the Complaint, is denied without costs.

/s/ LAWRENCE A. WHIPPLE
U.S.D.J.